United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-2048

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In The

United States Court of Appeals

For The Second Circuit

COMPETITIVE ASSOCIATES, INC.,

Appellant,

vs.

LAVENTHOL, KREKSTEIN, HORWATH & HORWATH,
MORTON DEAR, ROBERT BIER and THOMAS MARTINO,

Appellees,

On Appeal from the United States District Court
for the Southern District of New York.

REPLY BRIEF FOR APPELLANT COMPETITIVE ASSOCIATES, INC.

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The issues, the statement of the case, and the course of proceedings below are discussed in appellant's initial brief and are not repeated in this reply brief.

POINT I

APPELLEE BEARS THE BURDEN OF PROOF ON ITS MOTION FOR SUMMARY JUDGMENT AND CAN NOT DIVEST ITSELF OF THAT BURDEN ON THIS APPEAL

The theme of the brief of defendant-appellee LKH&H is that in the district court Competitive Associates (plaintiff-appellant) did not offer sufficient evidence to defeat summary judgment. Therefore, it must be reemphasized that on summary judgment motions the burden of proof lies with the moving party, as defendant LKH&H admits (Appellee's brief, 41-42).* Because issues of fact abound, and because it did not present acceptable evidence sufficient to foreclose the need for a trial of those issues, defendant LKH&H now attempts to shift the burden to plaintiff. In this regard its first tactic is to belittle the opposing affidavit of Mr. Marshall (Br 7; A 92a). However, the Marshall affidavit is simply a mirror image of the Lesch affidavits, which are all defendant LKH&H offered in support of its motion. The Lesch affidavit is an attorney's affidavit; it could not, and does not, profess any personal knowledge of facts relevant to the issues presented.

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* Hereinafter references to appellee's brief are noted as "Br", and references to the appendix are noted as "A".

Additionally, both the Lesch and Marshall affidavits excerpt and annex transcripts of testimony of other persons. If the Marshall affidavit is deficient, its deficiency is exceeded by the Lesch affidavit in that the burden of proof lies with the moving party.

The second tactic is outright misstatement. This is most apparent on page 38 of appellee's brief, where the following statement is made:

> There is simply nothing in the record, nor even in the allegations of the complaint, indicating (1) who the investors in Takara Partners were, (2) that such investors were especially wealthy or well-known, . . .

The untruth of this assertion is demonstrated by pages 96a-99a of the Appendix, where the name and address of every alleged investor in Takara Partners is listed. The wealth and public reputations of people like John Burns, Richardson Dilworth, Lawrence Ellman, and Keith Funston cannot be disputed. Appellee's statement that there is "nothing in the record" about the investors in Takara Partners is outrageous.*

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* A similar over-statement occurs at page 32 of appellee's brief where it is asserted that the record proves that LKH&H was not mentioned at any of plaintiff's board meetings. This apparently is based only on the formal minutes of those meetings and a portion of the Markizon deposition which is not part of this record (see A 55a, last line of paragraph 12).

The third tactic employed in the effort to shift the burden of proof is to impose upon plaintiff an obligation to conduct depositions (Br 44). No such obligation exists, particularly in the present case where the moving party itself has failed to depose critical witnesses. Appellant's initial brief discusses the inadmissibility of the purported Randolph testimony. Appellee has countered with two arguments: (1) that the Randolph excerpts are admissible because no objection was made, and (2) that, although there was no opportunity for cross-examination, the excerpts can be used on a summary judgment motion because they are the equivalent of an affidavit.

Reference to pages 93a and 94a of the Appendix will dispose of the first argument. Mr. Marshall there made clear and repeated objection to consideration of the purported Randolph testimony.

The second argument is equally unfounded. Defendant LKH&H admits that the Randolph testimony is not a "deposition" within the meaning and requirements of the Federal Rules of Civil Procedure. Nevertheless it asserts that a defective deposition can be considered as an affidavit. The short answer is that these Randolph testimonial excerpts are not an affidavit. The essence

of an affidavit is the signature of the affiant, after administration of the oath, and after review and correction of the statement. There is no showing that the Randolph excerpts were reviewed, corrected, signed, or sworn to; much less all four. How they could be the equivalent of an affidavit is not explained, and no authority contrary to Blum v. Campbell, 355 F. Supp. 1220 (D. Md. 1972) is offered.

Laying these tactics aside, the question before this Court is whether the accounting defendants carried their burden in foreclosing the existence of triable issues of fact.

The primary issue of fact with respect to causation is: but for the acts and omissions of the accounting defendants would plaintiff have retained, and continued with, Yamada? The corollary issue of fact is: but for the retention of Yamada would plaintiff have engaged in the securities transactions which resulted in the losses here claimed?

Defendant LKH&H urges a much narrower issue of fact: namely, did plaintiff see the false and misleading financial statements prior to retaining Yamada? As pointed out in appellant's initial brief, even this issue is triable. However, it must be reemphasized that this

is not the primary issue of fact material to causation. It is only one of several sub-issues encompassed within the above-stated primary issue. For example, plaintiff sustained its losses in securities transactions instituted several months after Yamada was retained initially. Thus another sub-issue of fact exists as to whether plaintiff saw the false and misleading financial statements after Yamada's initial retention but before institution of all of the loss generating securities transactions. The summary judgment record made by the accounting defendants does not speak to this sub-issue.

As a second example, prior to plaintiff's retention of Yamada, but after promulgation of the false and misleading financial statements, plaintiff's representative, Randolph, interviewed Yamada and people having knowledge of Yamada.* The record demonstrates that Randolph and Yamada discussed the financial status of Takara Partners and that they looked at certain financial statements (A 146a). The record does not prove that Randolph

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* See A 94a where Randolph purportedly said that he checked with "people in the business who had done business with him and who had known him" (referring to Yamada). In a footnote at page 30 of its brief defendant LKH&H concedes that Randolph interviewed Yamada. In addition, plaintiff believes that Randolph spoke to John Burns. Although the record does not establish that, the reference to "City Assoc." at the bottom of the June 12, 1970, letter (A 96a) suggests it. The other notations on that letter suggest other conversations.

did not discuss the financial performance of Takara Partners with others whom he interviewed. Thus a sub-issue of fact exists as to whether Randolph was informed orally of the false and incomplete picture portrayed by the financial statements certified by the accounting defendants. The summary judgment record made by the accounting defendants does not speak to this sub-issue either.

As a third example, the district court held that the false and misleading financial statements were not prepared either for plaintiffs or for the investment community in general. That determination is error. There is no evidence at all on the record as to whom the financial statements were reasonably calculated to influence, as to who actually received them, and generally as to the intentions of the co-conspirators at defendant LKH&H who received pay-offs for their certification of the financials.

The list of sub-issues of fact could be lengthened. However, the point is made by these three examples. In the district court, and again on this appeal, defendant LKH&H has focused attention on one narrow sub-issue and argued that it is not genuinely triable. This is a deception. Whether or not that single fact is genuinely triable, it is not dispositive. As a matter of law,

plaintiff may prove its case under the 1933 and 1934 acts without proving that it saw the false and misleading financial statements.

At the trial of this action plaintiff will have to prove causation. That plaintiff saw the false and misleading financial statements before retaining Yamada would be one form of causation -- one method of proof. It is not the only one, as the above examples illustrate. However, it is the only one to which defendant LKH&H addressed itself on the summary judgment motion. No proof was offered to foreclose any of the various other forms of causation. Thus the accounting defendants failed to carry their burden of proof.

POINT II

THE LEGAL ISSUES PRESENTED BY THIS APPEAL ARE CONTROLLED BY THE RECENT SUPREME COURT DECISIONS IN BANKERS LIFE AND AFFILIATED UTE

The argument of defendant LKH&H is based upon (1) three lower court cases (none of them in this circuit) in which the courts had a full record upon which to determine the material fact issues; and (2) a complete disregard of dispositive Supreme Court law on the scope of §10(b) of the 1934 Act, particularly with respect to causation and "in connection with a purchase or sale of securities".

Defendant LKH&H cites and relies heavily upon Landy v. F.D.I.C., 486 F.2d 139 (3d Cir. 1973); Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971) and Caddell v. Goodbody & Co., CCH [1973 Transfer Binder] Fed. Sec. L. Rep. ¶93,938 (N.D. Ala. 1972). Of these cases, only Landy discusses and concerns itself with the Supreme Court's "touch test" as enunciated in Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Co., 404 U.S. 6 (1971). Wessel was decided before Bankers Life; Caddell unaccountably disregards Bankers Life.

In Landy the defendant-accountant was relieved of §10(b) liability solely on the court's finding that the reports he had certified were not made in a manner reasonably calculated to influence the investing public and were not disseminated to the public. Similarly, in Wessel there was no showing that the certified financial statements had been disseminated, nor that the statements were false or misleading. In addition, in both Landy and Wessel, unlike the present case, there were factual determinations that the accountants had not participated actively in the distribution to the public of the false financial information. Landy cites Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967) for the same proposition: namely, the accountant would be liable if he assisted or

encouraged the corporation in the public use of inaccurate financial statments.

The factual determinations were made in Wessel only after the plaintiff had been allowed to present his evidence at trial.

In the present case the plaintiff has been denied any opportunity to address itself to the fact issues regarding the purpose for preparation of the false statements and the breadth of their dissemination. The moving party, defendant LKH&H, did not offer any evidence on these matters. The district court made a bald finding that "the pivotal fact is that the December 31, 1969 Takara Partners financial statements were not prepared either for plaintiffs or for the investment community in general" (A 199a). There is simply no evidence in the record on any aspect of this question.

Thus neither Landy nor Wessel can have any bearing on the present case unless and until a record is made with respect to: (1) the breadth of the dissemination of the false and incomplete financial statements; (2) the intention of Yamada and the accounting defendants as to the distribution of the statements, including who they were reasonably calculated to influence; and (3) whether the accounting defendants in any manner participated or assisted, in the preparation of the letter

of June 12, 1970 from Yamada to Randolph (96a-99a) which was seen and relied on by plaintiff.

Strikingly, in Landy and Wessel the participation of the accountants was passive by comparison to the central role of the accounting defendants in the present case. Here it is alleged that employees of defendant LKH&H accepted pay-offs from Yamada (A 14a).

Defendant LKH&H also cites Landy for their contention that judgment in their favor is justified because of plaintiff's alleged lack of reliance on the false financial statements. Once again, however, the Landy treatment of the reliance question is entirely based on the court's determination that the accountant's report was not prepared for, or disseminated to, the public. Thus the discussion of reliance in Landy is really duplicative of the "in connection with" findings since the court states that if the accountant's report had been prepared for the public, reliance would be presumed. In other words, as plaintiff has argued throughout, there is no reliance requirement in this case; rather there is only a causation-in-fact test. Affiliated Ute Citizens v. U.S., 406 U.S. 128 (1972).

The third case relied on by defendant LKH&H, Caddell v. Goodbody & Co., supra, is an Alabama District

Court case which, although decided in 1972, for some reason totally ignores Bankers Life. In discussing the "in connection with" requirement of §10(b) it states that "There is nothing in those decisions [S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) and Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968)] to indicate that misstatements about one company's financial condition will create liability for a loss from a sale or purchase of another corporations securities." The Supreme Court, however, had already determined that just such a liability can arise under §10(b). In Bankers Life, the "misstatements" (actually a failure by the co-conspirators to disclose to Manhattan Casualty Co. a scheme to loot its assets) were made to the plaintiff (actually to his predecessor in interest, the Manhattan Casualty Co.) about the plaintiff's own status in a take-over. However, the securities which the Supreme Court found had been "purchased or sold", so as to satisfy the "in connection with" requirement of §10(b), were those of an entirely unrelated third party -- the U.S. Government.

The recent decisions of this Circuit Court fully recognize that the Bankers Life case changed the state of the law under §10(b). For example, in Drachman

v. Harvey, 453 F.2d 722 (2d Cir. 1972) plaintiff, shareholders, sued derivatively to recover losses suffered by their corporation when the controlling shareholders conspired to sell out their controlling interest and then to remain on the board of directors where they caused an improvident redemption of convertible debentures. Upon first hearing, this court affirmed dismissal of the action holding that a Rule 10b-5 claim was not stated because the alleged fraud was not "in connection with the purchase or sale" of securities. The court said at p. 732:

> In short, §10(b) liability arises only when the alleged fraud between the parties and/or alleged market manipulation or deception is intrinsic to the securities transaction itself. Where this prerequisite is not met, as here, no federally cognizable interest exists and the complaint must be dismissed.

On rehearing, after the Supreme Court's decision in Bankers Life, this court gave full recognition to the redefined standard of "in connection with" and reversed the district court's dismissal and found that a sufficient claim of fraud in connection with a purchase of securities had been stated.

A similar decision was reached most recently in Schlick v. Penn-Dixie Cement Corp., ___ F.2d ___ (2d Cir. 1974). In this case, the defendant was alleged to have bought a controlling interest in Continental Steel Corp.

and then manipulated and depressed the market value of Continental's stock so that a merger between the two corporations could be entered into at an exchange ratio unfair to Continental. In connection with the merger defendant issued a proxy statement which failed to disclose that Penn-Dixie had inflated the value of its shares at Continental's expense. Once again, relying on Bankers Life and Drachman this court found that the alleged violations had a sufficient connection with the sale and purchase of shares effectuated by the merger.

Defendant LKH&H attempts to distinguish the Schlick case, in which plaintiff was required to prove only "loss causation", by suggesting that the plaintiff here must show "transaction causation" or reliance as well.

This is a case in which the accounting defendants made affirmative misstatements. They also failed to disclose material information, and the non-disclosures were no less damaging to plaintiff than the misstatements. Yamada's alleged pay-offs to the accounting defendants, as specifically alleged in the complaint herein, of course was the most material of the non-disclosures (A 14a). Defendant LKH&H argues that in a case like the present where the defendants are accused of misrepresentations

and non-disclosures plaintiff must prove reliance upon the misrepresentations as a prerequisite to recovery on the basis of the non-disclosures (B 29-30). The illogic of this argument is even more striking in view of defendant LKH&H's concession that reliance need not be proved in cases where only non-disclosures are alleged (B 28). It seems defendant LKH&H would have this court impose a heavier burden on a plaintiff who has been defrauded by misrepresentations and non-disclosures than on a plaintiff who has been defrauded only by non-disclosures. Obviously the proper rule is to assess liability under each separate unlawful act (whether misrepresentation or non-disclosure) by the standards applicable to that variety of act.

It also must be remembered that not every violation of the anti-fraud provisions of the federal securities laws can be, or should be, forced into a category headed "misrepresentations" or "non-disclosures". Fraudulent devices, practices, schemes, artifices, and courses of business also are interdicted by the statutes. The acts and omissions of Yamada and the accounting defendants fit these terms as easily as they do "misrepresentation" and "non-disclosure". Causation-in-fact, not direct, inflexible reliance, is the standard which best can be applied to the endless varieties of securities fraud.

In short, if plaintiff's damage was caused by fraud committed by the accounting defendants they may not avoid liability by disproving direct reliance upon an affirmative misrepresentation which was but one part of the scheme.

The Schlick case, itself, deals with a similar type of fraudulent series of transactions and makes this point. The court stated:

> Under the 10b-5 count, proof of transaction causation is unnecessary by virtue of the allegations as to the effectuation of a scheme to defraud which includes market manipulation and a merger on preferential terms, of which the proxy omissions and misrepresentations are only one aspect. N.Y. L. J., Nov. 4, 1974 at 6.

CONCLUSION

This action raises important questions regarding the application and scope of the "touch" test of Bankers Life and the "causation-in-fact" approach of Affiliated Ute and Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974) . Also it will determine whether a loss of several million dollars ultimately should fall upon the hundreds of public shareholders of plaintiff or upon Yamada, the accounting de-

fendants, and others who acted in concert with them. Matters of this magnitude must be decided only upon a full record, not upon the affidavits of two attorneys (Lesch and Marshall -- neither professing any personal knowledge), portions of a deposition of the former assistant counsel of plaintiff's fund manager (Markizon), and excerpts of an unsworn, unsigned, uncross-examined deposition (Randolph). On this appeal fraud and damage are admitted; the issue is whether difficult questions of causation-in-fact should be decided on scraps of untested evidence or only after a full trial and airing of all admissible evidence. Plaintiff does not ask for judgment, only for a day in court.

Respectfully submitted,

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IS HEREBY ADMITTED.

DATED: Dec 11, 1974

Willkie Farr & Gallagher

AttorneyS for Lummus [illegible] KH&W

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Reply Brief

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R. Turner

ROGERS & WELLS
ATTORNEYS FOR

DATED: DEC 12 1974

Attorney for

~~STATE OF NEW YORK~~
~~COUNTY OF NEW YORK~~

~~being duly sworn deposes and says: On , 19 I served the within record on appeal brief appendix the attorney for the respondent by leaving mailing three copies thereof at his office located at~~

~~Sworn to before me this day of , 19~~

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DATED: 12/11/74

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